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**SFA**



**BILL ANALYSIS**

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Senate Bill 618 (Substitute S-2 as reported)  
Sponsor: Senator Valde Garcia  
Committee: Economic Development, International Trade and Regulatory Affairs

Date Completed: 6-17-02

**RATIONALE**

A key element in fostering economic development and promoting job creation is the availability of capital investment in small businesses, entrepreneurial ventures in distressed areas, and high-technology start-ups. Venture capital firms (businesses that offer financial and strategic planning resources to young companies) often are the source of this type of investment. Apparently, this financial support is lacking in Michigan. Reportedly, the State ranks 44th in the amount of venture capital available to start-up companies in Michigan, and even lower in the amount actually invested in them. Evidently, the State ranks higher in the total amount of capital raised for this purpose, but much of that money ends up invested in out-of-State interests. In order to assure that venture capital companies develop and remain in Michigan and that their investments go to in-State businesses, some people believe that Michigan should offer tax credits to businesses that invest in certified capital companies that, in turn, offer venture capital to Michigan-based small business concerns or businesses that are located in distressed areas, with particular emphasis on investment in early-stage businesses involved in high-technology activity.

**CONTENT**

The bill would create the "Certified Capital Company Act" to provide a 100% single business tax credit to a "certified investor" (a company subject to the Single Business Tax that invested at least \$2 million of certified capital) that made an investment in a certified capital company. The certified capital company then would have to make qualified investments in a qualified business (a small business concern or a business in

an eligible distressed area), according to a schedule and criteria specified in the bill.

The bill would do all of the following:

- Limit the total credits claimed under the bill by all taxpayers to \$200 million.
- Provide for the Department of Treasury to allocate tax credits.
- Specify procedures for certification by the Department of a certified capital company, including collection of a \$7,500 application fee and an annual \$5,000 certification fee.
- Specify a schedule and criteria for a certified capital company's investments, and otherwise regulate certified capital companies.
- Allow a certified capital company to request a written opinion from the Department as to whether a specific business was a qualified business and request an opinion from the Michigan Economic Development Corporation (MEDC) as to whether a business was an early stage business engaged in high-technology activity or had its principal business operations located in one or more eligible distressed areas.
- Allow a certified capital company to make a qualified distribution at any time, but restrict other distributions from certified capital.
- Specify a procedure for decertification of a certified capital company as well as the recapture of tax credits previously claimed and the forfeiture of future tax credits by certified investors in a decertified capital company.

- **Restrict certified investors' control over a certified capital company.**
- **Allow a certified investor to transfer or sell a vested credit only to an individual, corporation, association, partnership, or other legal entity subject to the Single Business Tax.**

#### Defined Terms

"Certified capital company" would mean a partnership, corporation, trust, or limited liability company, regardless of whether it was organized on a profit or not-for-profit basis, that had as its primary business activity the investment of cash in qualified businesses and that was certified by the Department of Treasury as meeting the bill's criteria. "Qualified business" would mean a business other than one predominantly engaged in professional services provided by accountants, lawyers, or physicians that, at the time of a request for a written opinion of the Department of Treasury or the MEDC, or, if no request were made, at the time of the initial investment in the business, had its headquarters or principal business operation located in Michigan and was a small business concern as defined in the Code of Federal Regulations (13 CFR 121.201) and/or had its principal business operations located in one or more eligible distressed areas.

"Certified investor" would mean an individual, corporation, association, partnership, or other legal entity that was subject to tax under the Single Business Tax Act as of the date of its initial investment of certified capital and that invested at least \$2 million of certified capital pursuant to an allocation of tax credits under the bill. "Certified capital" would mean an investment of cash by a certified investor in a certified capital company that fully funded the purchase price of an equity interest in the company or a qualified debt instrument issued by the company.

#### Tax Credit

A certified investor that invested certified capital pursuant to an allocation of tax credits under the bill would earn a vested tax credit against its tax liability equal to 100% of its investment. A certified investor would be entitled to take a maximum of 10% of the vested tax credit in any tax year beginning with the year during which the investment was made. The tax credit that could be claimed in

any one year could not be more than the certified investor's tax liability for that year. All unused tax credits could be carried forward until they were used up.

The Department of Treasury would have to allocate tax credits in the order in which it received tax credit allocation claims. Within 10 days after receiving a tax credit allocation claim from a certified investor, the Department of Treasury would have to notify that investor of the amount of the tax credits allocated to the investor. If the certified investor did not invest certified capital in a certified capital company within 10 business days after receiving an allocation, the investor would forfeit that portion of the allocation not invested.

A certified investor, on an aggregate basis with its affiliates, could not file tax credit allocation claims under the bill, whether in one or more certified capital companies, for more than 15% of the total maximum aggregate amount of tax credits allowed under the bill or \$2 million, whichever was greater.

A certified capital company could file tax allocation claims on behalf of its certified investors at any time after it became certified but not earlier than May 31, 2002. Tax credits could be claimed or otherwise used with respect to tax years beginning on or after January 1, 2002.

A certified investor that was an insurer and that claimed a credit under the bill would not have to pay any additional tax levied under the Insurance Code as a result of claiming the credit. A certified investor that was an insurer would not be required to reduce the amount of tax liability under the Single Business Tax Act included in connection with rate making for any insurance contract written in Michigan because of a reduction in the certified investor's tax based on the credit.

A certified investor could transfer or sell a vested credit according to rules promulgated by the Department only to an individual, corporation, association, partnership, or other legal entity subject to the SBT. A transfer or sale would not affect the time schedule for taking the tax credits.

#### Application for Certified Capital Company

The Department of Treasury would have to

begin accepting applications for certification of a certified capital company by October 31, 2001. An applicant would have to pay a nonrefundable application fee of \$7,500.

A certified capital company's net worth at the time of seeking certification would have to be at least \$500,000, determined by the company's unencumbered cash, marketable securities, and other liquid assets. The Department would have to review each applicant's organizational documents and business history and determine whether the applicant's net worth met that standard.

At least two principals of a certified capital company or a person employed to manage a company's funds would have to have at least two years of experience in the venture capital industry.

Within 30 days of the filing of an application, the Department would have to issue a certification as a certified capital company or refuse to issue a certification. If the Department refused certification, it would have to communicate in detail to the applicant the grounds for the refusal, including suggestions for remediation.

Each certified capital company would have to pay an annual, nonrefundable certification fee of \$5,000 to the Department of Treasury.

#### Certified Capital Company Investments

Within three years after its allocation date, a certified capital company would be required to have made qualified investments cumulatively equal to at least 30% of its certified capital. Within five years, the company would have to have made qualified investments cumulatively equal to at least 50% of its certified capital. For purposes of satisfying these percentage requirements, the company would be considered to have invested \$2 for every \$1 invested in a qualified business that had its principal business operations in one or more eligible distressed areas.

All certified capital not placed in qualified investments could be held or invested in a manner that the company considered appropriate. The company could not invest more than 15% of its certified capital in only one qualified business.

("Allocation date" would mean the date on which the certified investors of a certified capital company were allocated tax credits by the Department of Treasury. "Qualified investment" would mean the investment of cash by a certified capital company in a qualified business for the purchase of any debt, equity, or hybrid security, of any nature and description, including a debt instrument, debt participation, or security that had the characteristics of debt but that provided for conversion into equity or equity participation instruments such as options or warrants. "Eligible distressed area" would mean an eligible distressed area as defined in the State Housing Development Authority Act (MCL 125.1411), that was classified as such at the time of a request for a written opinion of the Department of Treasury or the MEDC under the bill or, if no request were made, at the time of the initial investment in the business.)

Each certified capital company would have to report all of the following to the Department of Treasury and to the MEDC:

- As soon as practicable after receiving certified capital, the name of each certified investor, the amount of each investor's investment and tax credits, and the date on which the capital was received.
- By January 31 of each year, the amount of the company's certified capital at the end of the preceding calendar year; whether the company had invested more than 15% of its total certified capital in any one business; a description of all qualified investments that the company made during the preceding calendar year; a description of all investments in early stage businesses engaged in high-technology activity made during the preceding calendar year; and a description of all investments in qualified businesses with principal business location in one or more eligible distressed areas made during the preceding calendar year.
- Within 90 days after the close of each fiscal year, an audited financial statement that included the opinion of an independent certified public accountant (CPA), and a report prepared by the CPA addressing the methods of operation and conduct of the business of the company to determine if it was in compliance with applicable statutes and rules and that the funds it received had been invested as required under the bill.
- By January 31 of each year, an annual

report of the economic impact of the company's investments in the preceding calendar year with specific identification of the investment in qualified businesses engaged in high-technology activity or with principal business operation in one or more eligible distressed areas.

"Early stage business" would mean a business that, at the time of a request for a written opinion of the Department of Treasury or the MEDC or, if no request were made, at the time of the initial investment in the business, met one or more of the following conditions:

- The business was engaged in activities related to the development of initial product or service offerings.
- The business was less than two years old.
- During the fiscal year preceding the request for a written opinion of the Department or the MEDC or, if no request were made, during the fiscal year preceding the initial investment in the business, it had gross revenues of no more than \$3 million calculated on a consolidated basis according to generally accepted accounting principles.

"High technology activity" would mean one or more of the following:

- Advanced computing, which would be any technology used in the design and development of computer hardware and software, data communications, or information technologies.
- Advanced materials, which would be materials with engineered properties created through the development of specialized process and synthesis technology.
- Biotechnology, which would be any technology that used living organisms, cells, macromolecules, microorganisms, or substances from living organisms to make or modify a product, improve plants or animals, or develop microorganisms for useful purposes. Biotechnology would not include human cloning.
- Electronic device technology, which would be any technology that involved microelectronics, semiconductors, electronic equipment, and instrumentation, radio frequency, microwave, and millimeter electronics, and optical and optic-electrical devices, or data and digital communications

and imaging devices.

- Engineering or laboratory testing related to the development of a product.
- Technology that assisted in the assessment or prevention of threats or damage to human health or the environment, including environmental cleanup technology, pollution prevention technology, or development of alternative energy sources.
- Medical device technology, which would be any technology that involved medical equipment or products, other than a pharmaceutical product, that had therapeutic or diagnostic value and was regulated.
- Product research and development.
- Advanced vehicles technology that was any technology involving electric vehicles, hybrid vehicles, or alternative fuel vehicles, or components used in their construction.

#### Investments: Written Opinion

Before making a proposed investment in a specific business, a certified capital company could request a written opinion from the Department of Treasury as to whether the business was a qualified business and an opinion from the MEDC as to whether the business was an early stage business engaged in high-technology activity or had its principal business operations located in one or more eligible distressed areas.

The Department or the MEDC, as applicable, would have to notify the company of its opinion within 10 days after the request was made. If the Department or the MEDC determined that a business did not meet those definitions, it would have to provide an explanation of its determination. If the Department or the MEDC failed to respond within 10 days, the business would be considered to be a qualified business or an early stage business engaged in high-technology activity, or to have its principal business operations located in an eligible distressed area, as applicable.

The Department could determine that a business was a qualified business or the MEDC could determine that a business was an early stage business engaged in high-technology activity, even if the business did not meet either definition in the bill, if the Department or the MEDC determined that an investment in

the business by a certified capital company would further economic development in Michigan.

### Qualified Distributions

A certified capital company could make a qualified distribution at any time. In order to make a distribution or payment from certified capital, other than a qualified distribution or a payment to debt holders, a certified capital company would have to have made qualified investments in an amount cumulatively equal to at least 100% of its certified capital with at least 20% of its certified capital invested in early stage businesses engaged in high-technology activity.

("Qualified distribution" would mean a distribution or payment by a certified capital company from certified capital in connection with any of the following:

- Reasonable costs and expenses of forming and syndicating the company.
- Reasonable costs and expenses of managing and operating the company, including an annual management fee that did not exceed 2.5% of the company's certified capital.
- Any projected increase in Federal or State taxes, including penalties and interest related to income taxes, of the company's equity owners resulting from the earnings or other tax liability of the company or the equity owners to the extent that the increase was related to the ownership, management, or operation of the company or the issuance, repayment, or redemption of its qualified debt instruments.)

Payments to debt holders could be made without restriction with respect to repayments of principal and interest owed, including indebtedness on which certified investors earned tax credits. A debt holder that also was a certified investor or equity holder could receive payments with respect to the debt without restrictions.

The Department of Treasury annually would have to determine whether the aggregate total of distributions from certified capital, excluding qualified distributions, to each certified capital company's certified investors and equity holders, when combined with all tax credits allocated to and used by the

certified investors, resulted in an annual internal rate of return that exceeded 15% on the certified capital allocated to the certified investors plus any additional capital contributions to the company. If, as of the date of that determination, the company's annual internal rate of return exceeded 15%, the company would have to pay to the Department an amount equal to 30% of any subsequent distributions from the certified capital, other than qualified distributions, above the amount required to produce a 15% return.

### Decertification, Recapture, and Forfeiture

The Department of Treasury would have to conduct an annual review of each certified capital company to determine if it was abiding by the certification requirements, to advise the company as to the eligibility status of its qualified investments, and to ensure that its investments were not in violation of the bill. The Department could not charge more than \$5,000 for the review and would have to be paid by each certified capital company.

Any material violation of the bill regarding a certified capital company's investments would be grounds for decertification. If the Department determined that a company was not in compliance with the bill's provisions pertaining to investments, the Department, by written notice, would have to inform the company's officers that it could be subject to decertification in 120 days unless the deficiencies were corrected. At the end of the 120-day period, if the company were still not in compliance with the bill, the Department could send a notice of decertification to the company and to all other appropriate State agencies.

Decertification could cause the recapture of tax credits previously claimed and the forfeiture of future tax credits to be claimed by certified investors. Decertification before the company had made qualified investments of 30% of its certified capital within three years would cause the recapture of all tax credits previously claimed and the forfeiture of all future tax credits to be claimed by certified investors. If, after initial certification, a company failed to have made qualified investments of 50% of its certified capital within five years after having met the 30%-in-three-years requirement, the first 30% of

vested tax credits that could be claimed by each certified investor would not be subject to recapture or forfeiture. The remainder of the vested tax credits of each certified investor, however, would be subject to recapture or forfeiture. If a company met the 50%-in-five-years requirement, and subsequently were decertified, the first 50% of the vested tax credits would not be subject to recapture or forfeiture but the remainder of the tax credits would be.

If a certified capital company had invested an amount cumulatively equal to 100% of its certified capital in qualified investments, all tax credits claimed or to be claimed by its certified investors would no longer be subject to recapture or forfeiture. If a company had invested an amount cumulatively equal to 100% of its certified capital in qualified investments and had met all other requirements under the bill, the company would no longer be subject to the bill or to regulation by the Department of Treasury.

#### Certified Investors

Under the bill, a certified investor or any affiliates of a certified investor could not do any of the following:

- Directly or indirectly beneficially own, whether through rights, options, or convertible interests, 10% or more of a certified capital company's equity securities.
- Manage a certified capital company.
- Control the direction of investments for a certified capital company.

Those restrictions, however, would not preclude a certified investor or any other person from exercising its legal rights and remedies, including interim management of a certified capital company in the event that a company was in default of its statutory or contractual obligations.

### **ARGUMENTS**

*(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)*

#### **Supporting Argument**

Positioning Michigan for a future of economic growth and diversity depends on the

development of new and progressive businesses in the State. By providing SBT credits to a business that invested in a new type of venture capital company called a certified capital company (also commonly referred to as a "capco"), the bill would help to foster economic development in Michigan. The proposed tax credits would provide an incentive for investment in capcos, and capcos would have to invest the funds in Michigan-based small business concerns or companies that had their principal business operations in a distressed area. In addition, the bill would help ensure that investment in capcos would aid in the development of new, forward-looking businesses, by requiring that 20% of the investment be directed toward companies that engaged in high-technology activity. This type of investment, in turn, should spur business growth and job creation that would benefit both Michigan's economy and the State's tax revenues.

#### **Supporting Argument**

Michigan reportedly has not fared well in providing venture capital for business development in the State. According to testimony before the Senate Committee on Economic Development, International Trade and Regulatory Affairs by a venture capitalist who previously had started several small businesses in Michigan, he had difficulty raising business start-up funds in this State. He informed the Committee that Michigan ranks 44th among the states in the amount of venture capital available and even lower in the amount of venture capital invested. Apparently, much of the venture capital actually raised in Michigan ends up being funneled into out-of-State business development interests. By providing for a system under which venture capital would be invested in Michigan-based companies, the bill should improve Michigan's standing as a location that is friendly to new business development. In the long-run, the bill would help to keep small, developing companies in Michigan and to draw business development interests from outside the State.

#### **Opposing Argument**

Although the capital investment system proposed by the bill could be beneficial to the State's economy in the long-run, the timing of this proposal is not good. Since the State is facing a major budget shortfall and must either reduce and eliminate programs or raise

taxes, offering an SBT credit to businesses that invest in capcos may be ill-advised at this time.

**Response:** The bill would limit the total tax credit available to \$200 million and would allow a business to claim a maximum of 10% of its credit in any given year, so the cost to the State in the form of SBT credits would not be more than \$20 million per year. In addition, there would be a return on the State's investment in the form of the generation of new and growing companies and job creation. Those companies and workers would increase the State's tax rolls. Also, the bill specifies that, if a capco's annual internal rate of return exceeded 15%, the capco would have to return a portion of that excess to the State.

Further, other states that have passed capco laws also have had budget problems. Those states reportedly have addressed that situation by delaying the tax credit by one or two years, and Senate Bill 618 could be amended to do that, too. This approach would allow funds to be raised immediately for business development while postponing the impact on State revenues. By the time the SBT credits were claimed, the State would be collecting increased revenue in the form of business and income taxes from the new business start-ups benefitting from capco investment and their employees.

### **Opposing Argument**

The bill would undermine Michigan's retaliatory tax on out-of-State insurers operating in Michigan, because it would permit them to take the proposed tax credit but would not require them to pay any additional tax levied under the Insurance Code. Insurance retaliatory laws provide that, when the laws of another state ("foreign state") impose greater burdens, including taxes, upon insurance companies domiciled in the retaliating state, then the retaliating state can impose the same burdens upon insurers domiciled in the foreign state. So, for instance, if Ohio taxes Michigan insurers operating in Ohio at a higher rate than is levied in Michigan on foreign insurers, then Michigan may tax Ohio companies operating in this State at that higher rate. Retaliatory laws, then, discourage excessive taxation of out-of-state insurers and encourage foreign states to reduce their taxes on those insurers.

If foreign insurers operating in Michigan were able to claim an SBT credit under the bill without paying the retaliatory tax levied under the Insurance Code, they would no longer pay Michigan taxes equal to the higher taxes imposed on Michigan insurers by their home states and, as such, would be operating at an advantage over Michigan insurance companies operating in foreign states. Michigan would be especially affected by this because its base rate of insurance company taxation is among the lowest in the nation. The bill should be amended to allow a foreign insurer a credit against its SBT liability, as long as that liability, after the capco credit, was not less than a Michigan insurer would owe on a similar type and volume of insurance business written in the foreign insurer's home state.

Legislative Analyst: Patrick Affholter

### **FISCAL IMPACT**

No reasonable estimate of the fiscal impact of this bill can be made at this time, because there are too many unknown factors. The key unknown factors include: 1) the number of businesses that would qualify as certified investors, 2) the amount these certified investors would invest in qualified activities, and 3) whether these investments would occur anyway without this new proposed tax credit. Although the bill would limit the total amount of tax credits to \$200 million, there is no way to know how much of these credits would be claimed in any one year, or how many years it would take for these credits to be fully claimed.

An application fee of \$7,500 would be charged to capital companies applying for certification. Once approved, a \$5,000 annual fee would be imposed on each certified capital company to continue its certification status. In addition, the Department of Treasury could assess a fee of up to \$5,000 to conduct an annual certification review of each certified capital company. The collected fees would benefit the General Fund and the revenue collected would depend upon how many companies would be certified and require a review.

Implementation of this bill would require a new review and approval function of the Department of Treasury. Since the number of applications that would be received is unknown, the potential staffing needs of the

Department are indeterminate.

The bill also would increase the administrative responsibilities of the Michigan Economic Development Corporation by requiring it to publish opinions on the status of certain companies with no clear revenue source to support these activities.

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